

REDMOND'S OPERATING ENVIRONMENT

This section provides the economic background for the City of Redmond and the context in which the 2003-2004 Operating Budget was developed. Included in this section is a summary of national and local economic conditions and an overview of the major factors impacting the long-term financial health of the City and the greater Puget Sound region.

NATIONAL ECONOMY

Recession similar to the 1981-82 recession with a longer trough

After experiencing unprecedented growth in the late 1990s, the nation experienced its first economic recession in ten years. What was expected to be a short downturn with a quick recovery is currently seen as a much more severe recession. This recession will be a prolonged one similar to the one in 1981-82, but with a longer trough and slower recovery. A national recovery is not expected until early 2004.

Why will this recession last longer than the 1981-82 recession?

While it took 10 quarters from the start of the recession of 1981-82 for the economic recovery to start, the rebound from the recent recession may not occur as quickly. Specifically, the economic recession of 1981-82 lasted six quarters, and started to recover 12 months later. If the past is a predictor of the future, the recovery would begin during the second quarter of 2003. However, current economic conditions do not appear to warrant this conclusion for the following reasons:

Weak signs of recovery

Many economic indicators continue to show signs of a weak economy. Unemployment jobless claims stayed very high, exceeding 400,000 claims for the fourth straight week for the period ending September 14th. The increase in unemployment raises a question for the sustainability of future retail spending, especially when the unemployment rate is expected to rise even higher before the economy fully recovers. Consumer spending held strong and grew earlier this year, giving hopes for a rebound. However, since March, spending has steadily fallen.

Other signs of continued weakness in the economy include a rise in the poverty level of U.S. households and a slowing in the manufacturing industry. The share of households under the poverty level has increased in 2001 for the first time in eight years. Median household income fell 2.2% to \$42,228. Overall, consumers are feeling less optimistic about the near-term state of the economy. Only when consumers look into the future do they feel more optimistic about a recovery, according to a Conference Board survey.

Lack of fiscal stimulus available

Interest rates are already at their lowest points in decades, and there is a limit to how much further the Federal Reserve Bank can lower rates. The Federal Reserve Bank aggressively lowered interest rates 11 times during 2001 to 1.75% in response to the dramatic economic slowdown. This policy was effective in sustaining consumer spending, which drives two-thirds of the nation's economy, especially in the housing market. However, business investment stayed unaffected at a very low level. With interest rates already so low, the Federal Reserve Bank is running out of additional stimuli to boost the economy.

There have been discussions at the Presidential and Congressional levels about cutting taxes as a means to further stimulate economic activity. However, tax cuts are less desirable to governments during recessions when tax receipts are already lower than usual. The lack of additional stimuli poses uncertainty for the future if economic weakness continues.

Slowing housing market

Existing strength in consumer spending is largely a product of housing sales, which are the single largest component of consumer spending. This is a concern because the sales of existing homes as well as the number of housing starts are slowing. Once interest rates start to rise again home sales will slow even further. As housing sales significantly affect consumer spending, a slowdown in the housing market has the possibility of pushing the nation into a double-dip recession. This would be especially true if business investments have not turned up when the housing market stalls.

Accounting scandals and terrorism threats

Finally, a fourth major factor affecting the current state of the economy is continued reports of corporate scandals involving some of the largest U.S. entities such as Enron, WorldCom, Arthur Andersen, and Merrill Lynch. As a result, investor confidence has been fundamentally shaken. The deterioration in investor confidence has resulted in a further downward spiral in the stock market and with it the ability for legitimate businesses to raise capital and expand.

Compounding the delay in the economic recovery are ongoing terrorist threats and the uncertainty and international friction over a possible attack on Iraq. These issues will further delay the rebound of business investments which will act as an impediment to a recovery in the U.S. economy.

In summary, on the national level, the economy will take much longer to recover than originally expected. With this national economic background, what does it mean to the state of Washington and the Puget Sound region?

ECONOMY IN THE PUGET SOUND REGION***A greater blow***

The Puget Sound area will suffer from this recession more than other parts of the country and will lag behind the national average. Historically, Washington state has a tendency to lag behind the national pattern by six to nine months. However, this particular recession was unique as the Seattle economy was hit particularly hard and the local recovery is expected to be slower than usual. The Puget Sound economy is expected to remain fairly weak with a recovery not expected until late 2004 or early 2005.

It is noteworthy to highlight differences in the Puget Sound area economy between the recent recession and the one in the 1980s, as the variations between the two will help explain what may be in store for the regional economy in the near term.

Why was the Puget Sound area hit particularly hard?

Compared to the recession of the 1980s, during the recent recession there was much more damage to core industries in the Puget Sound area that support the local economy. The Puget Sound area is known for two specialized areas: aerospace and high-tech, the two industries that suffered the most during the recent recession.

Below are three reasons why the recovery in the Puget Sound region is expected to take longer than the one in the 1980s.

Changes in the aerospace industry and weakness in manufacturing

The first distinction between the most recent and the prior recession is the delayed recovery in the aerospace industry, which is not expected until 2004. In the previous recession, Boeing's job cuts were mainly due to the cyclical nature of supply and demand in the aerospace industry. Airplane

production levels rebounded when demand returned, resulting in an increase in aerospace employment and improved long-term employment growth in the Puget Sound area.

In contrast, Boeing is currently challenged with fundamental changes in the airline industry. The industry continues to remain weak as a result of reduced personal travel due to the September 11th terrorist attacks and decreased lucrative business travel after the decline in the telecommunications and high-technology sectors. The trouble in the airline industry is exemplified by recent filings for bankruptcy protection by Canada Airlines, US Airways and Vanguard Airlines and the announcement of serious financial trouble by United Airlines, the second largest airline in the U.S., and America West. Nearly all airlines are asking for assistance from the federal government. The ailing airline industry prompted Boeing, which is a major employer in the Puget Sound region, to continue cutting back employment.

Collapse of the high-technology industry

Secondly, the greater Seattle area was a home to many dot-com companies that showed unprecedented growth during the 1990s. The boom in the high-technology sector and lucrative stock options offered to the local workforce resulted in higher spending in this region.

With the decline in the high-tech sector, the Puget Sound area has lost many employers, high-paying jobs, income from lucrative stock options, and consumer spending on luxury goods. The region has lost one of its strongest business bases on which to rebuild the economy. Other cities with a high concentration of telecommunications and high-technology companies, such as Atlanta, Denver, Dallas and Salt Lake City, remain weak and also lag behind the national average.

Highest unemployment rate in the nation

During the 1981-82 recession, while Boeing shed 18,100 jobs, most of the local job losses occurred in the lumber and wood products industries and in construction jobs related to the construction of two nuclear power plants. As these job losses were located outside of the Puget Sound corridor, the economic impact of these losses was not directly felt in this area.

In contrast, the most recent economic recession resulted in more job losses in the Puget Sound area. Specifically, Boeing reduced its payroll by 20,200 employees, about 2,000 more positions than in 1981-82 according to the *Puget Sound Forecaster*. The decline in high-technology companies resulted in about 20,000 mostly permanent job losses. Not only were these jobs centralized in the Puget Sound corridor, but they were highly paid and their elimination resulted in a severe blow to the local economy. Local weakness in the job market has affected the state as a whole. Washington state posted a 7.2% unemployment rate in August 2002, marking the nation's highest level of unemployment.

On the national level, the unemployment rate is estimated to peak in 2003 followed by a recovery in 2004. However, at the local level the weakness in aerospace may cause the rebound of employment to be delayed by six months to a year. The state is expecting a very slow recovery of employment in the software industry, increasing by merely 1,400 jobs during 2003, a small fraction of the 20,000 jobs lost earlier. Furthermore, the state expects that employment in the manufacturing sector will decrease until 2003, with a very small uptick in 2004, and a more solid increase starting in 2005.

Adding to the troubles of the Puget Sound region is the labor dispute among longshoremen, the ports and steamship lines that recently shut down 29 ports on the West Coast. A five-day shutdown will cost the U.S. economy \$4.7 billion in wages and revenues, according to the Pacific Maritime Association, and as the economic effects snowball, a ten-day shutdown would cost \$19.4 billion. Although it is difficult to estimate how much of the revenue loss is expected in

Washington, this dispute is projected to have a considerable impact in this region because a significant portion of the economy is supported by two large ports in Tacoma and Seattle. Economists also warn that a prolonged shutdown would have even larger impacts as the land transportation industry would be hurt, merchandise inventory would be decreased in stores, and assembly lines might be stopped due to the lack of imported parts.

Because of the above factors the recovery from this recession will be particularly slow in the Puget Sound region. With this economic backdrop, what is expected for the City of Redmond? To answer the question, it is necessary to review how the City has changed over the past decade.

CHALLENGES FACING THE CITY OF REDMOND IN THE NEXT BIENNIUM

A dramatically changed city

During the last decade, the City of Redmond has grown tremendously. Since the early 1990s, residential population has increased 29%, the employment base has more than doubled, and the City has met 87% of its 2012 growth targets. In 1990, Redmond was the 7th largest city in King County. Today, Redmond remains the 7th largest city in King County and home to many major high-tech firms and retail companies.

Redmond Statistics	1990	2002	Percentage Change
Residential population	35,800	46,040	29%
Employment	30,101	72,247	140%
Commercial square footage	16.9 million	26.7 million	58%
Ranking in King County based on population	7	7	

The growth and continued attraction of Redmond as a place to live and work is clear. In 2002, the City added two additional major retailers: Home Depot, which opened in mid-2002, and Fred Meyer, which opened in late 2002. Additional major retailers scheduled to open for business in 2003 include the Bon Marche, Cost Plus Imports and a full-service Marriott Hotel. These activities are occurring while the region is in the grips of an economic downturn. In addition, Microsoft remains strong, increasing jobs in the region.

As the City enters 2003, it will be challenged to continue to provide quality services to a growing community as the economy remains weak. Approximately 41% of the City's General Fund revenues, which fund basic services such as police, fire, street maintenance, parks, etc., are highly sensitive to changes in the economy.

Impacts of the recession

To provide a perspective on how the economic recession has impacted the City, the following table shows how retail sales tax revenue, the City's largest revenue source, has declined in Redmond and in other selected jurisdictions between 2000 and 2001.

Decline in Sales Taxes Revenues, 2001 vs. 2000

Jurisdiction	Sales Taxes
Bellevue	-8.3%
Kirkland	-7.1%
Redmond	-6.6%
Seattle	-3.2%
Unincorporated King County	-2.8%

In response to the decline in revenues, the City of Redmond reduced its spending in the short-term and made long-term systemic changes in each department, especially in development review. Specifically, the 2003-2004 biennial budget eliminates 11.7 FTEs and reduces General Fund expenditures by \$2.7 million, of which approximately 50% is related to development review. The balance of the reductions includes reduced funding for operational departments including Finance, Human Resources, Fire, Police, Planning, Parks and Public Works.

Divestiture of programs at King County

In addition to the challenges within its own borders, Redmond must grapple with changes at King County in response to its growing fiscal crisis. In 2002, King County faced a current expense budget shortfall of \$41 million or 8% of its annual operating budget. In 2003, the County expects another \$50 million shortfall and a \$30 million shortfall in each of the following two years. The County's current expense fund is similar to the City's general fund and is used to support basic County services, such as district and superior courts, human services, parks, police, public health, and jail services.

Due to its fiscal crisis, King County has fundamentally changed the way many of its regional services are delivered, and has embarked on a policy of divesting itself of many services that were historically seen as a responsibility of the County.

Changes that the County has announced so far include the following:

Jail Services

Until 2002, King County had been seen as the regional provider of jail services, including for misdemeanor offenders. Cities regularly contracted with King County to provide housing and care of their inmates in exchange for a fee. This relationship has changed significantly as King County has announced that in the future it will no longer be in the business of providing misdemeanor jail services to cities. As a result the City of Redmond, along with many other cities in the Puget Sound region, entered into a multi-year contract with Yakima County to provide the majority of its misdemeanor jail services. The City is also working with Issaquah to provide for misdemeanor jail services. Although these changes may result in stabilizing the City's cost for inmate services, the long-term future of managing the misdemeanor jail population will pose challenges in the years ahead.

Parks and Pools

In 2002, as King County struggled with closing the \$41 million budget gap, a significant policy decision was made that the County will only support regional park assets such as Marymoor Park, the King County Fairgrounds, and the Weyerhaeuser Aquatics Center and parks that are located in unincorporated King County. Park facilities that are located inside city limits, including swimming pools (e.g. the King County Pool located on Education Hill) would either be transferred to cities or be closed indefinitely. Although discussions with King County continue, the decision to transfer or close such valued assets as parks and pools comes at a time when cities such as Redmond can least afford to support these services.

District Courts and Probation Services

The City currently contracts with the county to handle municipal court services. The Northeast Division of King County District Court processes the City's traffic and criminal cases, as well as limited civil cases. Services provided also include probation services for criminal offenders who have already served jail time and are under court order for monitoring.

In early 2002, the County Executive notified all of the cities that receive court services that these services would no longer be provided starting in 2005, with the expiration of the current contract, unless a new agreement is entered which provides for full cost recovery. Redmond is working

with other cities to jointly negotiate a new agreement with the county. At the same time, the City is performing its own analysis of options for court services, such as forming its own municipal court, so that it will be poised to determine which option best meets the needs of the City and its residents in a cost-effective and efficient manner.

Human Services

King County annually spends approximately \$12 million from its current expense fund on human services. These services have included support to the homeless, youth services, programs to support victims of domestic violence and sexual assault, community health clinics, and services for the low-income. To close the budget gap in 2003 and beyond, the County will likely reduce current expense support of its human services programs by \$6 million (or 50%) in 2003 and will likely eliminate the balance in 2004. Although the County has not yet finalized its budget decisions, these decisions will affect many of its most vulnerable citizens and will increase pressures on human service programs countywide to fill some of the gaps in service. The City is currently working with the County and other cities to identify a dedicated funding source in support of valuable and much needed human services programs.

In addition to the financial crisis facing King County and the potential service level impacts on Redmond and other cities, another financial challenge that may potentially have an impact on Redmond is the state's current operating budget shortfalls.

State's Fiscal Crisis

The state of Washington faced a \$1.6 billion shortfall during the 2002 legislative session. In order to close this budget gap, the state reduced or eliminated many state programs including funding for human services. Examples of human services that were affected include reduction in Medicaid payments to pharmacies and other health care providers, reduction in nursing home payment rates, and the elimination of payments to supplemental security income (SSI) recipients.

In 2003, legislators will be returning to Olympia to close an even larger budget deficit totaling \$2 billion at this writing. It is not clear which additional services will be affected; however, it is clear that given the financial constraints facing the state, great pressure will be placed on the Governor and the Legislature to further re-evaluate core state services and to consider reducing and or eliminating additional programs. These additional reductions may result in program and service level impacts at the County or local government levels.

Tax Initiatives

In addition to the financial challenges facing the state, the county, and local governments, several tax initiatives are on the November ballot for voter approval, all of which would have a significant impact on state, county and local governmental operations. These include the following:

Initiative 776 – \$400,000 annual loss to Redmond's Transportation Capital Improvement Program

Initiative 776 modifies state law by limiting license tabs for vehicles and light trucks to \$30. It repeals the \$15 local option vehicle license fee that is currently being levied in King, Snohomish, Pierce and Douglas counties. This initiative also eliminates Sound Transit's authority to levy a motor vehicle excise tax for high-capacity transportation and requires previously issued light rail bonds to be paid off using other sources of revenues. Estimated revenue losses over the next six years include \$121 million to the state of Washington, \$202.9 million to King, Snohomish, Pierce and Douglas counties and \$432 million to Sound Transit.

The estimated revenue loss to the City of Redmond's Transportation Capital Improvement Program between 2003 and 2008 is estimated at \$2.4 million, or \$400,000 annually. This potential

loss of revenue as a result of this initiative is not included in the City's 2003-2008 Transportation Capital Improvement Program.

Initiative 790 – additional cost to the City's General Fund of \$800,000 in 2003 rising to an additional \$3.1 million or more in 2004

Initiative 790 modifies how the current Law Enforcement Officers' and Firefighters' Retirement System Plan II (commonly referred to as LEOFF II) will be managed. LEOFF II is a retirement system currently administered by the state to provide retirement benefits to police officers and firefighters. The system is supported by contributions from employees, local government employers, and the state of Washington.

This initiative makes significant changes to the plan by:

- 1) shifting control of the pension system to a new eleven-member governance board appointed by the Governor. This board is made up of six LEOFF II members, three employer representatives and two members of the State Legislature;
- 2) requiring interest earnings over an assumed rate of return to be used exclusively to enhance benefits;
- 3) allowing the new governance board to authorize additional benefits costing 20% or less of LEOFF II employees' pay unless the State Legislature votes to repeal these increases; and
- 4) giving the new governance board the authority to propose benefit increases costing 20% or more of employees' pay with approval by the State Legislature.

According to the State Actuary, this initiative is estimated to increase contributions for employees from 4.39% to 25% of pay as early as July 1, 2003 and increase the employer contribution from 2.64% to 15.47%. The fiscal impact of this initiative on the City of Redmond is estimated to cost an additional \$818,000 in 2003, rising to an additional \$3.15 million or more in 2004, depending upon the extent additional benefits are authorized by the new governance board and the State Legislature. The City's 2003-2004 biennial budget does not include resources to support the potential fiscal impact of this legislation.

Referendum 51 – additional revenue of \$40,000 annually

Referendum 51, if approved, will raise \$7.7 billion for transportation and transit improvements in the next ten years, of which \$7.1 million would be distributed to cities with populations over 10,000. For the City, this referendum would result in an additional \$40,000 of revenue in 2003, which is not reflected in the City's budget.

The 2003-2004 biennium poses a period of great challenge for the City as the nation and the region experience the aftermath of the first economic recession after a decade of phenomenal growth. The challenges for Redmond over the next two years will be how to preserve quality City services with limited revenues, and how to balance the pressures to accept from other levels of government additional service responsibilities that do not have corresponding revenue increases to support them.